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THE REGULATION OF FUNDED SOCIAL SECURITY*

Deborah M. Weiss[†]

INTRODUCTION

The Social Security system is in need of reform. Most of its problems stem from the fact that it is unfunded; in other words, the Social Security system uses current receipts to pay benefits to current retirees. From the perspective of each individual worker, the Social Security system is a compulsory savings program. Individuals pay Social Security taxes during their working years and receive an annuity after retirement. From the perspective of the economy as a whole, however, the present Social Security system is not a form of savings. To create savings in the economic sense, resources that could be consumed now must be invested and used to produce new output that can be consumed in the future.

The unfunded financing of the current system creates two problems. First, national savings is lower than it would be with a funded system. Second, the system is vulnerable to demographic fluctuations so that small cohorts, like Generation Xers, will bear an enormous burden as they underwrite the retirement of large cohorts, like baby boomers.

A public retirement scheme need not be unfunded. Social Security payroll taxes could be invested in the private sector, and the return on these investments could be used to pay the annuities of retirees. Such a system would be called funded Social Security. Funding the Social Security system would solve two of the current system's principal problems, vulnerability to demographic swings and its adverse effect on the savings level. However, a funded Social Security system raises many difficult issues.¹

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¹ Perhaps the most difficult problem arises from the fact that the United

This Article will deal with one of those issues: A funded Social Security system would create a huge pool of assets. Those assets would have to be managed somehow, and this Article examines various approaches to the management of Social Security assets.

Any plan for managing Social Security funds must address two basic issues: (1) the investment policy the funds should follow and (2) who should manage the funds. These questions are intertwined, and succeeding sections of this Article will shift between them. Section I will examine the basic choice between active and passive investment and will argue that any privatized Social Security system must include some form of active management. Section II will look at who should manage funds and propose that financial intermediaries are better suited to this task than are individuals, government, or employers. Section III will propose a general fiduciary standard which should be imposed on all fund managers. I will propose a standard that modifies the current trust law prudent investor rule. Section IV will explore two methods of ensuring that financial intermediaries actually comply with the general proposed standard of prudence: (1) capitalization requirements and other devices to ensure that fiduciaries are not judgement proof and (2) additional restrictions on the investment policies that fund managers may pursue. The Conclusion will evaluate the principal reform proposals that have been recently introduced into Congress.²

States cannot enact retirement income policy from a clean slate. Any shift to a funded system would raise transition problems of intergenerational equity: either workers during the transition period would pay two sets of taxes, or retirees would get less than full benefits, or a combination of the two.

A second problem concerns the distributive effects of the system. The current Social Security system redistributes income to less affluent participants. Although a funded system could effect redistribution, none of the plans offered to date do so. Still another set of problems concern the treatment of household labor, generally by women, and the corollary issues of survivorship interests. *See generally* Karen C. Burke Grayson & M.P. McCouch, *Women, Fairness, and Social Security*, 82 IOWA L. REV. 1209 (1997).

² *See, e.g.*, H.R. 4076, 105th Cong. (1998) (Petri); H.R. 3560, 105th Cong. (1998) (Smith); H.R. 3456, 105th Cong. (1998) (Kasich-Shays, Miller, Graham, Blunt, Foley, Doolittle); S. 1792, 105th Cong. (1998) (Moynihan, Kerrey, Hollings); H.R. 3082, 105th Cong. (1997) (Smith, Porter, Campbell, Knollenberg, Houghton, and Sanford); H.R. 2929, 105th Cong. (1997) (Porter, Bachus, Shays, Smith, Livingston, Petri, Sanford, Parker).

I. SOUND INVESTMENT

A. *Modern Portfolio Theory*

Modern portfolio theory examines the optimal investment strategy for a risk-averse investor, or, in other words, an investor who wishes to obtain high returns at low levels of risk.

The central insight of portfolio theory is that risk is not additive: two properly chosen assets will generally be less risky than either asset alone. To reduce overall risk without reducing return, investors should look for assets whose risks are negatively correlated with each other. The precise risk of a portfolio combining two assets depends not only on the risk of each asset, examined in isolation, but on the correlation between the assets in the portfolio.³ As long as the two assets are not perfectly correlated, combining them can reduce portfolio risk below the level of either separately.

By proper diversification an investor can eliminate some, but not all, risk. The risk that can be eliminated is called diversifiable risk, or alternatively, unique or specific risk. Diversifiable risk is due to factors that are particular to a given company or industry. These factors include how well managed a company is, the quality and price of substitutes for the company's product, the prices of inputs and so on. Diversification mitigates the unique risk of one asset by offsetting that risk against the unique risk of another asset. After unique risk has been diversified away, the remaining risk is called the market risk. An asset's market risk is the extent to which the asset's price moves in the same direction as the market as a whole.⁴ Market risk is, in effect, the risk that the economy as a whole will prosper or decline.

In a well-functioning asset market, the return on an asset should not reflect the asset's unique risk, since unique risk can be diversified away. In contrast, the return on a stock should reflect market risk, since market risk cannot be eliminated through diversification. Since unique risk is not compensated,

³ See RICHARD A. BREALEY & STEWART C. MYERS, *THE PRINCIPLES OF CORPORATE FINANCE* 155-68 (4th ed. 1991); JAMES C. VAN HORNE, *FINANCIAL MANAGEMENT AND POLICY* 60 (10th ed. 1995).

⁴ BREALEY & MYERS, *supra* note 3, at 163.

no rational investor should ever bear unique risk.⁵ To avoid unique risk, investors should not make low risk investments but should choose a properly diversified portfolio. These principles have an important corollary, the so-called Separation Theorem.⁶ The Separation Theorem suggests that there is a single portfolio, called the market portfolio, that contains the optimal combination of risky assets for all investors, regardless of their risk preferences.

Rational investors can differ in the amount of market risk they choose to bear, since market risk is compensated. In order to tailor their portfolio to their individual risk preferences, investors should vary the proportion of assets they hold in the market portfolio and in risk-free assets, such as short-term Treasury bills.

Proposal One

The portfolio of a funded Social Security should contain the smallest possible level of unique risk.

B. *Active and Passive Investment*

The Separation Theorem has some important implications for individual investment decisions. It suggests that some investors can free ride off of the investment decisions of others by using a passive investment strategy.

Investors using an active investment strategy investigate stocks and choose investments on the basis of such factors as the long-term growth prospects of the company. An investor who uses a passive investment strategy designs his portfolio to reproduce the stocks in an index of funds, generally a broad-based index. The Separation Theorem implies that an individual investor can reap the benefits of the active investment policies of others by using the passive index fund as the market

⁵ See Eugene F. Fama, *Risk, Return and Equilibrium: Some Clarifying Comments*, 23 J. FIN. 29 (1968); John Lintner, *The Valuation of Risk Assets and the Selection of Risky Investments in Stock Portfolios and Capital Budgets*, 47 REV. OF ECON. AND STAT. 13 (1965); William F. Sharpe, *Capital Asset Prices: A Theory of Market Equilibrium Under Conditions of Risk*, 19 J. FIN. 425 (1964).

⁶ See James Tobin, *Liquidity Preference as Behavior Toward Risk*, 25 REV. OF ECON. STUD. 65 (1958).

portfolio and adjusting his total risk by combining the market portfolio with risk-free investments such as short term Treasury bills.

In designing an investment strategy for funded Social Security, the threshold question is whether funds should be managed actively or passively.

Passive index investing is an excellent approach, even an optimal one, for some investors. The pension fund for federal employees, the Thrift Savings Fund,⁷ has a well-designed passive index scheme.⁸ However, the fact that passive investing has worked well for the Thrift Savings Fund, and some other pension funds, does not imply that it is the right approach for a whole system of funded investing. Passive management works only if there are active investors. Investors can be active in two important ways. First, they can be active in the sense that they devote time and resources to investigating various companies in order to ascertain their value. Such efforts ensure that stocks are properly priced. Second, investors may become actively involved in the management of the companies in which they invest.⁹

Both types of active investing are important to the smooth functioning of the capital market. However, ascertaining how many active investors are needed to make the capital markets function efficiently is a difficult theoretical and empirical question. There is literature that suggests that, for some markets, the requisite number of well-informed investors is surprisingly small. These results, though, apply to markets for simple homogeneous goods like milk.¹⁰ Stocks, however, are a more complex and heterogeneous commodity, and buyers must incur higher search costs to guarantee an efficient outcome.

⁷ Federal Employees' Retirement System Act of 1986, Pub. L. No. 99-335, 100 Stat. 514 (1986) (codified at 5 U.S.C.S. §§ 8432 *et seq.* (1998)).

⁸ 5 U.S.C. §§ 8437-39 (1998).

⁹ See, e.g., Ian Ayres & Peter Cramton, *Relational Investing and Agency Theory*, 15 CARDOZO L. REV. 1033 (1994); Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124, 129-42 (1994).

¹⁰ See Alan Schwartz & Louis Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630 (1979).

Indeed, an important body of research suggests that too much index investing may cause asset markets to stop functioning altogether. Trades occur only when buyers and sellers place different values on the asset being traded. Often, such differences will be the result of different beliefs by the parties about the value of the asset, and such differences are in turn the result of the parties' efforts to investigate the stocks. With many index funds, most parties in the markets will be operating on the same strategy, lowering the volume of trading and at some point causing the markets to stop functioning well.¹¹

The number of investors who must be actively involved in corporate governance is also extremely difficult to ascertain. Many observers believe that the number of such active investors has already been reduced to a dangerously low level by several aspects of the current regulatory regime¹² and encouraging more passive investment would make a bad situation worse.

Clearly, a funded Social Security system would be very large, and requiring a passive investment policy would create a significant risk of reducing both types of active investment below the acceptable level.

Thus, I propose that any plan for a funded Social Security system allow for at least some funds to be actively managed.

¹¹ See Lawrence R. Glosten & Paul R. Milgrom, *Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders*, 14 J. FIN. ECON. 71 (1985); Thomas A. Gresik & Mark A. Satterthwaite, *The Rate at Which a Simple Market Converges to Efficiency as the Number of Traders Increases: An Asymptotic Result for Optimal Trading Mechanisms*, 48 J. ECON. THEORY 304 (1989); Paul Milgrom & Nancy Stokey, *Information, Trade and Common Knowledge*, 26 J. ECON. THEORY 17 (1982); Robert Wilson, *Incentive Efficiency of Double Auctions*, 53 ECONOMETRICA 1101 (1985). I thank Eric Talley for pointing these issues out to me.

¹² See, e.g., Gregory S. Alexander, *Pensions and Passivity*, 56 LAW & CONTEMP. PROBS. 111, 124 (1993); Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 873-88 (1992); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 575-91 (1990); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1366-68 (1991); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 882-92 (1991); Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 53-65 (1991).

Proposal Two

At least some privatized Social Security funds should be actively managed.

II. WHO SHOULD MANAGE FUNDS?

The proposition that some Social Security funds must be actively managed has implications for the question of who should manage these funds. A funded Social Security system could be either a single public fund managed by the government or could consist of individual privatized accounts. Such individual accounts could be managed either by individuals, by the government, by private professional fund managers, or by employers. In this section I will argue that the need for active fund management dictates decentralized private accounts, and that these funds are best managed by financial professionals.

A. *The Case Against Government Management*

Whether a government can successfully manage the Social Security trust fund appears at first to be a straightforwardly ideological issue that depends on one's views about the proper size of government. Yet, even relatively enthusiastic advocates of government intervention in the economy should be skeptical about the wisdom of government-managed Social Security. A privatized Social Security system is too large to be managed passively without impeding the efficiency of the capital market, but governmental agencies are unlikely to be effective active managers. Managers will only have an incentive to invest wisely if they are subject to market pressure from other investors competing to ascertain which stocks are the best values. This kind of competition cannot occur with any monopoly, whether governmental or private. Moreover, active government investment raises the possibility of what might politely be called cronyism. The Thrift Savings Fund for federal employees

recognizes both these difficulties by requiring passive investment of funds¹³ and precluding the exercise by the Fund or its agents of voting rights in Fund-held equity.¹⁴

For these reasons, a government-run funded Social Security system should be unappealing even to those who believe that governments have an important role to play in correcting market imperfections, providing public goods, and redressing distributional inequities. Moreover, while I will argue later that government should play an important role in regulating privatized Social Security, government should not attempt directly to manage Social Security investments. This in turn implies that funded Social Security should take the form of individual accounts.

B. *The Case Against Employers as Account Managers*

Eliminating government leaves three potential account managers: individual participants; private professional fund managers and employers. If employers are involved, they can either manage directly or act as intermediaries between employees and professional fund managers

The private pension system provides some evidence about employer management of retirement funds. Under ERISA, employers are the primary fiduciaries of pension plans. The pension experience suggests, however, two problems with employer management: lack of competence and conflicts of interest.

1. Competence

Large employers in general do a fairly competent job of managing their pension funds. However, small and medium sized employers, even with the best of intentions, are not always very good at direct fund management.

These smaller plans often make investment decisions with little guidance, and when they do consult financial advisors, they may choose those advisors unwisely. In particular, they often make fundamental mistakes in their asset allocation,

¹³ See 5 U.S.C. § 8438(b)(2) (1998) (requiring index investing).

¹⁴ See 5 U.S.C. § 8438(f).

often underinvesting in equity and overinvesting in real estate or cash equivalents.¹⁵ In the context of ERISA, smaller firms should be encouraged to delegate to fund managers or engage in passive strategies.¹⁶ However, since a privatized Social Security system would be starting afresh, there seems to be no good reason not to eliminate employers-as-fiduciaries, using them, at most, as conduits for contributions.

2. Conflicts of Interest

Employers of any size face conflicts of interest, and numerous reported ERISA cases testify to the frequency with which these conflicts create problems.¹⁷ An employer-run system of private accounts would require rules analogous to ERISA's prohibited transactions rules.¹⁸ The prohibited transactions rules greatly complicate the job of active portfolio management either by employers or by fund managers they engage. While an ordinary fund manager must guard only against invest-

¹⁵ Deborah M. Weiss & Marc A. Sgaraglino, *Prudent Risks for Anxious Workers*, 1996 WIS. L. REV. 1175 (1996).

¹⁶ See *id.* at 1202-12.

¹⁷ See, e.g., *Wood v. Comm'r*, 955 F.2d 908 (4th Cir. 1992); *Brock v. Citizens Bank of Clovis*, 841 F.2d 344 (10th Cir. 1988); *Leigh v. Engle*, 727 F.2d 113 (7th Cir. 1984); *Donovan v. Cunningham*, 716 F.2d 1455 (5th Cir. 1983); *Donovan v. Mazzola*, 716 F.2d 1226 (9th Cir. 1983); *Cutaiar v. Marshall*, 590 F.2d 523 (3d Cir. 1979); *Harris Trust & Sav. Bank v. Salomon Bros.*, 20 Employee Benefits Cas. (BNA) 1902 (N.D. Ill. 1996); *Cosgrove v. Circle K Corp.*, 915 F. Supp. 1050 (D. Ariz. 1995), *aff'd*, 1997 U.S. App. LEXIS 3853 (9th Cir. Feb. 27, 1997); *In re Gulf Pension Litig.*, 764 F. Supp. 1149 (S.D. Tex. 1991), *aff'd sub nom.* *Borst v. Chevron Corp.*, 36 F.3d 1308 (5th Cir. 1994); *Brock v. Hendershott*, 8 Employee Benefits Cas. (BNA) 1121 (S.D. Ohio 1987), *aff'd*, 840 F.2d 339 (6th Cir. 1988); *James A. Dooley Assocs. Employees Retirement Plan v. Reynolds*, 654 F. Supp. 457 (E.D. Mo. 1987); *Danaher Corp. v. Chicago Pneumatic Tool Co.*, 633 F. Supp. 1066 (S.D.N.Y. 1986); *Donovan v. Schmoutey*, 592 F. Supp. 1361 (D. Nev. 1984); *Sixty-Five Sec. Plan v. Blue Cross & Blue Shield*, 588 F. Supp. 119 (S.D.N.Y. 1984); *Donovan v. Daugherty*, 550 F. Supp. 390 (S.D. Alaska 1982); *McDougall v. Donovan*, 552 F. Supp. 1206 (N.D. Ill. 1982); *Weisler v. Metal Polishers Union*, 533 F. Supp. 209 (S.D.N.Y. 1982); *Gilliam v. Edwards*, 492 F. Supp. 1255 (D.N.J. 1980); *M & R Inv. Co. v. Fitzsimmons*, 484 F. Supp. 1041 (D. Nev. 1980), *aff'd*, 685 F.2d 283 (9th Cir. 1982); *Marshall v. Carroll*, 2 Employee Benefits Cas. (BNA) 2491 (N.D. Cal. 1980), *aff'd*, 673 F.2d 1337 (9th Cir. 1982); *Marshall v. Cuevas*, 1 Employee Benefits Cas. (BNA) 1580 (D.P.R. 1979); *Marshall v. Kelly*, 465 F. Supp. 341 (W.D. Okla. 1978); *Marshall v. Snyder*, 430 F. Supp. 1224 (E.D.N.Y. 1977), *aff'd in part and remanded in part*, 572 F.2d 894 (2d Cir. 1978); *Huge v. Old Home Manor, Inc.*, 419 F. Supp. 1019 (W.D. Pa. 1976).

¹⁸ See 29 U.S.C. § 1106 (1998).

ments that conflict with his own interest, an employer-sponsored manager must also avoid conflicts with the interests of the employer and related parties.

Eliminating the government and employers leaves two potential candidates to manage privatized accounts: individuals and professional fund managers.

C. *The Case Against Individual Investment*

Many workers lack financial sophistication. Evidence suggests that participants in self-directed accounts unintentionally take on unique risk. In particular, many investors, apparently seeking a maximally risk-averse course, inadvertently assume unnecessary unique risk by investing heavily in debt instruments such as Guaranteed Investment Contracts ("GICs"), which are fixed income assets that include no equity component.¹⁹ Moreover, even the more financially sophisticated employees often fall into behavioral investing traps.²⁰ For example, investors tend to look at upside and downside positions in separate frames of reference which leads to phenomena such as unnecessary risk-taking and overpriced downside protection.²¹ In addition, investors may have an aversion to regret which is stronger when the investor takes a positive action that fails than when the investor does nothing and passively loses money. Such emotions discourage the investor from making decisions in which he must take responsibility for the final outcome and will lead to selling winners too early and riding losers too long.²²

¹⁹ See Lee Berton, *Many GICs Have Lost Value, But Holders May Not Be Told*, WALL ST. J., Feb. 3, 1995, at C1; Karen Slater Damato, *For Market-Weary, GICs Make Sense . . . or Do They?*, WALL ST. J., Apr. 13, 1994, at C1; Mary Rowland, *Waking Up Your Savings Plan at Work*, N.Y. TIMES, June 25, 1994, at A37.

²⁰ See Jeffrey N. Gordon, *Employees, Pensions, and the New Economic Order*, 97 COLUM. L. REV. 1519, 1557-58 (1997); Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627 (1996).

²¹ See Hersh M. Shefrin & Meir Statman, *Behavioral Portfolio Theory* (Sept. 1994) (unpublished manuscript, on file with author).

²² See, e.g., Shlomo Benartzi & Richard H. Thaler, *Myopic Loss Aversion and the Equity Premium Puzzle*, 110 Q.J. ECON. 73 (1995); Daniel Kahneman et al., *Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias*, J. ECON. PERSP., Winter 1991, at 193, 194; Hersh M. Shefrin & Meir Statman, *Explaining Investor Preference for Cash Dividends*, 13 J. FIN. ECON. 253 (1984).

Indeed, as Professor Kathryn L. Moore points out, there seems to be a certain inconsistency between the paternalistic forced savings that is at the heart of Social Security and the assumption that individuals are competent to manage their own investments.²³

D. *Professional Fund Managers*

So far I have argued that neither government, employers, nor individuals should manage a funded Social Security system. This leaves, by default, professional fund managers as the only potential administrators.

Proposal Three

Social Security accounts should be individualized and managed by investment professionals rather than participants, employers, or the government.

Almost by definition, professional fund managers—or at least some of them—will have the expertise necessary to invest prudently. Yet, this does not mean that they should be left to invest individual Social Security accounts without restriction. In the next sections, this Article will address the regulatory regime that should be applied to the managers of individualized accounts.

III. A PROPOSED GENERAL FIDUCIARY STANDARD

A professionally managed system could still leave room for individuals to choose among professionally managed funds. Indeed, since some participants will be well-informed, allowing choice will impose a desirable degree of market pressure on managers.

Fortunately, the Social Security system need not rely wholly on monitoring by well-informed participants to protect less informed participants. The Separation Theorem implies

²³ Kathryn L. Moore, *Privatization of Social Security: Misguided Reform*, 71 TEMP. L. REV. 131, 132 (1998).

that the Social Security system can impose a mild degree of paternalism without interfering with the choices of better informed participants.

As a general policy objective, managers of privatized accounts should be obligated to try to eliminate diversifiable risk, but they should be permitted to assume a wide range of levels of market risk. This section will discuss how such a general policy objective could be translated into a statutory standard based on the law of trusts.

A. *General Trust Law Standard*

Traditional trust principles imposed two requirements on trust investments: Those investments must be individually prudent, understood to mean low in risk,²⁴ and the portfolio as a whole must be diversified.²⁵ This requirement was, in theory, entirely independent of the prudence requirement,²⁶ so that trust investments were required to be both diversified and individually prudent.

As many commentators noted, the individual prudence requirement violated the principles of modern portfolio theory.²⁷ In 1990, the Restatement (Third) of Trusts replaced the traditional prudent man rule with a new prudent investor rule.²⁸ The Restatement (Third) unequivocally rejected the re-

²⁴ The traditional prudent man rule, as stated in section 227 of the *Restatement (Second) of Trusts*, required the trustee "to make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate." RESTATEMENT (SECOND) OF TRUSTS § 227 (a) (1959).

²⁵ See *id.* § 228.

²⁶ See *id.* § 228 cmt. a.

²⁷ See Harry E. Bines, *Modern Portfolio Theory and Investment Management Law: Refinement of Legal Doctrine*, 76 COLUM. L. REV. 721 (1976); Jeffrey N. Gordon, *The Puzzling Persistence of the Constrained Prudent Man Rule*, 62 N.Y.U. L. REV. 51 (1987); Edward C. Halbach, *Trust Investment Law in the Third Restatement*, 77 IOWA L. REV. 1151, 1169-70 (1992); Paul G. Haskell, *The Prudent Person Rule For Trustee Investment And Modern Portfolio Theory*, 69 N.C. L. REV. 87, 108-10 (1990); John H. Langbein & Richard A. Posner, *Market Funds and Trust Investment Law*, 1976 AM. B. FOUND. RES. J. 1.

²⁸ The prudent investor "standard . . . is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy." RESTATEMENT (THIRD) OF TRUSTS § 227 (1990). The Reporter's comments clearly endorse the central principle of modern portfolio theory: any rational investor should eliminate unique risks. *Id.* at cmt. e. Courts have not yet

quirement of individual prudence and replaced it with a requirement, consistent with modern portfolio theory, that prudence be evaluated not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy.²⁹

Abandonment of the individual prudence requirement by the Restatement (Third) represents a clear improvement over traditional trust law.

B. *Content of Prudence Standard*

The Restatement (Third) improves traditional trust law by eliminating the individual prudence requirement. In this respect it should serve as a model for Social Security privatization legislation. However, the Restatement (Third) has at least two potential problems as a model for Social Security: (1) the exception for situations in which it would not be prudent to diversify and (2) the nature of its diversification standard.

1. Problem I: "Unless Prudent Not To" Diversity

The Restatement (Second) provided a limited exception to the diversification requirement: A trustee was not required to diversify if "under the circumstances it is prudent not to do so."³⁰ This exception, though, was carefully limited to unusual circumstances, such as widespread economic downturns or where trust funds were exceptionally small.³¹ This rule has been retained in the Restatement (Third) and in ERISA,³² which contains fiduciary rules intended to follow the common law of private trusts.³³

The unless-prudent-not-to exception is not self-evidently misguided, and has created no problems in the law of trusts, where it has remained a narrow and seldom-used exception.³⁴

had the opportunity to apply the *Restatement (Third)* standard.

²⁹ RESTATEMENT (THIRD) TRUSTS § 227 (1990).

³⁰ RESTATEMENT (SECOND) OF TRUSTS § 228 (1959).

³¹ *Id.* § 228 cmt. c.

³² Employment Retirement Income Security Act, Pub. L. No. 93-406, 88 Stat. 832 (1974) (codified as amended at 29 U.S.C. §§ 1001 *et seq.* (1994)).

³³ See U.S. CODE CONG. & AD. NEWS, 93d Cong. 4639, 5186 (remarks of Sen. Williams).

³⁴ Since the rule stated in this section is an application of the general rule

In a sense it is trivial: If nondiversification is prudent, obviously a prudent trustee should not diversify. However, this apparently innocuous phrase has wrought havoc with ERISA fiduciary law. In theory, ERISA requires both prudence³⁵ and diversification.³⁶ In practice, judges have interpreted "unless prudent not to" to mean that fiduciaries can either diversify or choose individually prudent investments.³⁷ Where plan investments can possibly be construed as individually prudent, courts virtually never find liability.³⁸

The reluctance of courts to impose liability for mere non-diversification has several causes. First, ERISA contains no general explanation of the diversification standard.³⁹ This lack of statutory guidance has compounded the inevitable difficulties that courts have had in applying the standard.⁴⁰ Sec-

stated in § 227, there may be special circumstances in which the trustee is excused from diversifying investments. Thus, where the trust estate is very small it may be proper for the trustee to invest the whole or substantially the whole of it in one security or type of security. So also, in times of crisis and general financial instability, it may be proper to invest a large portion or even the whole of the trust estate in a single type of security such as government securities. See RESTATEMENT (SECOND) OF TRUSTS § 228 cmt. c.

³⁵ ERISA requires fiduciaries to act "with the care, skill, prudence, and diligence . . . that a prudent man acting in like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." 29 U.S.C. § 1104(a)(1)(B) (1994); ERISA § 404(a)(1)(B).

³⁶ See 29 U.S.C. § 1104(a)(1)(C); ERISA § 404(a)(1)(C).

³⁷ See *Etter v. J. Pease Constr. Co.*, 963 F.2d 1005 (7th Cir. 1992); *Reich v. King*, 867 F. Supp. 341 (D. Md. 1994); *Lanka v. O'Higgins*, 810 F. Supp. 379 (N.D.N.Y. 1992); *Jones v. O'Higgins*, 11 Employee Benefits Cas. (BNA) 1660 (N.D.N.Y. 1989); see also *Weiss and Sgaraglino*, *supra* note 15, at 1190-92.

³⁸ Courts have found the diversification requirement violated in investments that are concentrated in a limited geographic area, see *Brock v. Citizens Bank*, 841 F.2d 344 (10th Cir. 1988); *Donovan v. Guaranty Nat'l Bank*, 4 Employee Benefits Cas. (BNA) 1686 (S.D. W. Va. 1983), but even this rule is not applied consistently. See, e.g., *Reich v. King*, 867 F. Supp. 341 (D. Md. 1994); see also *Weiss and Sgaraglino*, *supra* note 15, at 1193.

³⁹ ERISA provides no definition of diversification either in the Fiduciary Duty or General Definitions sections. See 29 U.S.C. §§ 1002, 1104 (1994); ERISA §§ 401, 407.

⁴⁰ Like everyone else (including generations of economists), courts do not find portfolio theory intuitively obvious. Accordingly, they have struggled to discern what Congress intended. In this effort, courts have looked to the statutory text and the legislative history of ERISA, but both have proven misleading. Like the Restatement (Second), ERISA provides that the objective of diversification is "to minimize the risk of large losses." 29 U.S.C. § 1104(a)(1)(C); ERISA § 404(a)(1)(C). "Large losses, courts seem to have reasoned, were unlikely to result from low risk investments. This is probably true, but large losses are even

ond, a few courts are actively hostile to portfolio theory.⁴¹ Finally, courts seem unwilling to impose liability on employers who have made a good faith effort, however much it may have fallen short.⁴²

Perhaps a privatized Social Security system could safely retain the unless-prudent-not-to exception. The exception has not grown out of control in the law of trusts. In ERISA, the problem, in part, seems to be judicial solicitude for well-meaning but naïve employers, a problem that would not arise if, as I suggest, accounts are managed by professional fund managers.

On the other hand, ERISA case law has all but gutted the diversification requirement. Since it is almost impossible to imagine circumstances under which a retirement account should assume diversifiable risk, I am, therefore, inclined to leave the unless-prudent-not-to exception out of the text of any privatization statute

2. Problem II: Nature of Diversification

The Restatement (Third) prudent investor rule requires: “§ 227(b) In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so.” This standard is, taken by itself, unobjectionable, but it is incomplete. The diversification implied by portfolio theory is more specific than the diversification of traditional trust law. An efficiently diversified portfolio requires a very specific combination of assets that takes into consideration correlations, as well as risk and return. The Restatement (Third) notes that investments must be evaluated in the context of the portfolio as a whole, but the rule itself does not mention the elimination of unique risk as the basis for evaluating the overall portfolio.⁴³ Although the Reporter’s comments to the Restatement

less likely to result from a diversified portfolio. This mistake was reinforced by a passage in the legislative history.” Weiss and Sgaraglino, *supra* note 15, at 1193-94.

⁴¹ See Reich, 867 F. Supp. at 341; see also Weiss and Sgaraglino, *supra* note 15, at 1194-95.

⁴² See *Bisceglia v. Bisceglia*, No. 92-16561, 1994 U.S. App. LEXIS 3370 (9th Cir. Feb. 17, 1994); see also Weiss and Sgaraglino, *supra* note 15, at 1195-96.

⁴³ “(a) [The prudent investor] standard . . . is to be applied to investments not

(Third) lucidly describe the principle of eliminating unique risks,⁴⁴ they disavow a commitment to any particular rule of investing.⁴⁵

Privatized Social Security requires something more explicit. The case law under ERISA illustrates the problems that can result from an insufficiently specific standard. ERISA in theory imposes two basic duties on pension fiduciaries: to invest prudently⁴⁶ and to diversify.⁴⁷ Where plan investments are not individually prudent, courts have found inadequate diversification only if the fiduciary has placed a large percentage of the plan assets into a single investment.⁴⁸

These rules apply to all funds, whether or not they allow workers to choose from varying investment vehicles. One potential model can be found in Regulations under ERISA governing self-directed accounts. Section 404(c) of ERISA and the Regulations under it currently permits fund managers to relieve themselves of much of their fiduciary obligation by providing participants with a range of choices that meet specified criteria. The Regulations relieve a self-directed plan of liability

in isolation but in the context of the trust portfolio and as a part of an overall investment strategy. RESTATEMENT (THIRD) OF TRUSTS § 227 (1990).

⁴⁴ See *id.* at cmt. e. Like the Restatement, legal critics of the traditional prudent man rule emphasized the importance of rejecting individual prudence rather than requiring the elimination of unique risk. See Bines, *supra* note 27, at 721; Gordon, *supra* note 27, at 51; Halbach, *supra* note 27, at 1169-70; Haskell, *supra* note 27, at 108-10; Langbein & Posner, *supra* note 27, at 1.

⁴⁵ The comments state that the Restatement rules "are intended to reflect the lessons derived from modern experience and research, without either endorsing or excluding any particular theories of economics or investments." RESTATEMENT (THIRD) OF TRUSTS § 227.

⁴⁶ ERISA requires fiduciaries to act "with the care, skill, prudence, and diligence . . . that a prudent man acting in like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." 29 U.S.C. § 1104(a)(1)(B) (1994); ERISA § 404(a)(1)(B).

⁴⁷ See 29 U.S.C. § 1104(a)(1)(C); ERISA § 404(a)(1)(C).

⁴⁸ For cases finding no liability with relatively little diversification, see *GIW Indus. v. Trevor*, 895 F.2d 729, 733 (11th Cir. 1990); *Jones v. O'Higgins*, 11 Employee Benefits Cas. (BNA) 1660 (N.D.N.Y. 1989); *Sandoval v. Simmons*, 622 F. Supp. 1174, 1211 (C.D. Ill. 1985); *Marshall v. Glass/Metal Ass'n*, 507 F. Supp. 378, 384 (D. Haw. 1980); *Marshall v. Teamsters Local 282 Pension Trust Fund*, 458 F. Supp. 986, 991-92 (E.D.N.Y. 1978); see also *Brock v. Citizens Bank*, 841 F.2d 344, 346 (10th Cir. 1988); *Rausch v. Damon*, No. 83-1161-CV-W-8, 1984 WL 3648 (W.D. Mo. Sept. 5, 1985) (consolidated with No. 84-0506-CV-W-8); *Marshall v. Mercer*, 4 Employee Benefits Cas. (BNA) 1523 (N.D. Tex. 1983); *Weiss and Sgaraglino*, *supra* note 15, at 1191-93.

for poor employee investment decisions if it makes available investment choices that, among other things, tend "to minimize through diversification the overall risk of a participant's or beneficiary's portfolio." The plan must provide participants with a broad range of investment alternatives.⁴⁹ At least three of these alternatives must be diversified,⁵⁰ and all must, in the aggregate, enable the participant to eliminate unique risk.⁵¹ However, each of these three in isolation need not eliminate unique risk, and participants can easily choose an underdiversified portfolio.⁵²

The Thrift Savings Fund for federal employees displays an oddly inconsistent attitude towards diversification. On the one hand, it provides participants with a well-designed menu of investment choices including a Government Securities Investment Fund, a Fixed Income Investment Fund, a Common Stock Index Investment Fund, a Small Capitalization Stock Index Investment Fund, and an International Stock Index Investment Fund.⁵³ On the other hand, it provides no mechanism for encouraging, let alone requiring, employees to hold efficiently diversified funds and even discourages optimal asset allocation by making the Government Securities Investment Fund the default choice⁵⁴ and requiring employees who choose other funds to sign a kind of assumption-of-risk form.⁵⁵

No privatized Social Security plan should permit the unintentional assumption of unique risk that can occur under the Thrift Savings Fund or ERISA self-directed plan Regulations. Each fund should be required "to minimize through diversification the unique, or diversifiable, risk of a participant's or beneficiary's portfolio."

⁴⁹ See 29 C.F.R. § 2550.404c-1(b)(1)-(3) (1998).

⁵⁰ See *id.* § 2550.404c-1(b)(3)(B)(1).

⁵¹ See *id.* § 2550.404c-1(b)(3)(B)(4).

⁵² See *id.* § 2550.404c-1(f)(5).

⁵³ See 5 U.S.C. §§ 8438 (b)(1), (d)(1) (1994).

⁵⁴ See *id.* § 8438 (c)(2).

⁵⁵ See *id.* § 8439(d).

Proposal Four

General Standard of Fiduciary Duty

In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust so as to eliminate unique or diversifiable risk.

The Social Security system might, on purely libertarian grounds, permit beneficiaries to assume unique risk. However, the system should place obstacles in the way of those who would choose undiversified investments. Some individuals may deliberately choose to undertake unique risk, but many do so under the mistaken assumption that they are choosing low risk investments. Before individuals are allowed to opt out of the basic diversified investment strategy, they should be required to receive information about the rationale behind the program and to sign elaborate consent or assumption-of-risk forms.

Unique risk, however, is not the only risk that the Social Security system must consider. No rational investor would assume unique risk, but investors may rationally choose different levels of market risk; that is, they make different tradeoffs between risk and return. At one extreme, rational individuals may choose to invest only in Treasury bills, thus assuming no market risk. A more typical rational investor might choose to hold the market portfolio. A more aggressive rational investor might choose to leverage the market risk by borrowing to purchase the market portfolio. A leveraged market portfolio would seem to defeat the purpose of a Social Security system, since an individual could end up not only without savings but in debt. However, although the system should probably not allow leveraged portfolios, I am inclined, on libertarian grounds to allow individuals to choose the level of market risk they assume. In other words, individuals should be able to choose how to allocate their portfolio between the market portfolio and risk-free assets.

Perhaps one further restriction on the assumption of market risk might be desirable. As individuals approach retirement, holding the market portfolio, without any risk-free component, becomes more problematic. If the individual retires during a low point of the business cycle, his portfolio's short-

term value will be worth less than its true long-term value. The Social Security system might, therefore, require individuals approaching retirement age to at least partially phase into risk-free assets.

Proposal Five

For most of their working life, individuals should be allowed to choose levels of market risk up to the level of the unleveraged market portfolio. As retirement nears, they should be required to hold some fraction of their portfolio in relatively risk-free assets.

IV. IMPLEMENTATION

A. *Regulation of Qualifications and Financial Soundness of Managers*

No fiduciary standard will have much effect if trustees are incompetent or judgement proof. In this respect the Thrift Savings Fund may provide a good model. Assets in the Fixed Income Investment Fund must, with a few exceptions, be chosen by a qualified professional investment manager.⁵⁶ In order to be a qualified professional investment manager, individuals must, roughly speaking, be subject to a regulatory regime such as the Investment Advisors Act and meet financial requirements that guarantee that they are not judgement proof.⁵⁷ A

⁵⁶ See 5 U.S.C. § 8438 (b)(1)(B).

⁵⁷ The term "qualified professional asset manager" means:

(A) a bank, as defined in section 202(a)(2) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(2)) which—

(i) has the power to manage, acquire, or dispose of assets of a plan; and

(ii) has, as of the last day of its latest fiscal year ending before the date of a determination for the purpose of this clause, equity capital in excess of \$ 1,000,000;

(B) a savings and loan association, the accounts of which are insured by the Federal Deposit Insurance Corporation, which—

(i) has applied for and been granted trust powers to manage, acquire, or dispose of assets of a plan by a State or Government authority having supervision over savings and loan associations; and

(ii) has, as of the last day of its latest fiscal year ending before the date of a determination for the purpose of this clause, equity capital or net worth in excess of \$ 1,000,000;

funded Social Security system should impose similar restrictions on the managers of privatized accounts.

Proposal Six

The management of individual accounts should be restricted to managers who meet specified registration requirements and who can be determined not to be judgement proof.

B. *Specific Asset Allocation Guidelines*

Another approach to regulating privatized accounts is to provide more specific guidelines for the investment of individual accounts.

(C) an insurance company which—

(i) is qualified under the laws of more than one State to manage, acquire, or dispose of any assets of a plan;

(ii) has, as of the last day of its latest fiscal year ending before the date of a determination for the purpose of this clause, net worth in excess of \$ 1,000,000; and

(iii) is subject to supervision and examination by a State authority having supervision over insurance companies; or

(D) an investment adviser registered under section 203 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3) if the investment adviser has, on the last day of its latest fiscal year ending before the date of a determination for the purpose of this subparagraph, total client assets under its management and control in excess of \$ 50,000,000, and—

(i) the investment adviser has, on such day, shareholder's or partner's equity in excess of \$750,000; or

(ii) payment of all of the investment adviser's liabilities, including any liabilities which may arise by reason of a breach or violation of a duty described in section 8477 of this title, is unconditionally guaranteed by—

(I) a person (as defined in section 8471(4) of this title) who directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the investment adviser and who has, on the last day of the person's latest fiscal year ending before the date of a determination for the purpose of this clause, shareholder's or partner's equity in an amount which, when added to the amount of the shareholder's or partner's equity of the investment adviser on such day, exceeds \$ 750,000;

(II) a qualified professional asset manager described in subparagraph (A), (B), or (C); or

(III) a broker or dealer registered under section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o) that has, on the last day of the broker's or dealer's latest fiscal year ending before the date of a determination for the purpose of this clause, net worth in excess of \$ 750,000 . . .

5 U.S.C. § 8438(a)(7).

Social Security legislation should restrict the percentage of funds that could be invested in the securities of any one issuer. Research suggests that holding as few as twenty randomly chosen stocks can yield most of the benefits of diversification.⁵⁸ Thus, the Social Security system might follow the example of the current law governing mutual funds under which a mutual fund, to qualify as diversified, may invest no more than 5 percent of its assets in the securities of any one issuer.⁵⁹

Even a 5 percent limit, however, would not ensure that Social Security investments were properly diversified. To eliminate unique risk, the investment selection mechanism must consider the covariance of each security against other securities in the portfolio.

I am reluctant to allow a government agency to set detailed guidelines for the elimination of unique risk. Although the broad outlines of sound investing are well-established, the more specific principles evolve rapidly and do not lend themselves to codification in the form of regulatory guidelines. Thus, a privatization statute probably should not attempt to regulate investment choices at a fine-grained level. Instead, the system should rely on the broad fiduciary requirement to eliminate unique risk, combined with effective personal liability for fund managers.

⁵⁸ See Robert A. Levy, *The Prudent Investor Rule: Theories and Evidence*, 1 GEO. MASON L. REV. 1, 12 (1994); see also Harry Markowitz, *Portfolio Selection*, 7 J. FIN. 77 (1952).

⁵⁹ See 15 U.S.C. § 80a-5(b)(1) (1994). However, mutual funds need not qualify as diversified. A more potent inducement to diversity can be found in the tax code. To qualify for pass-through tax treatment, the investment company must meet a more lenient diversification requirement provided in the Internal Revenue Code. First, with respect to 50% of the assets, no more than five percent of these assets may be invested in securities of any one issuer. See I.R.C. § 851(b)(4)(A) (1994). Second, no more than 25% of the value of the fund's total assets may be invested in the securities of any one issuer. See I.R.C. § 851(b)(4)(B); see also Mark J. Roe, *Political Elements in the Creation of a Mutual Fund*, 139 U. PA. L. REV. 1469, 1480 (1991).

However, not all ownership restrictions applicable to mutual funds serve legitimate objectives. To qualify as diversified and to qualify for pass-through tax treatment, a mutual fund may not own more than ten percent of the voting securities of an issuer. See 15 U.S.C. § 80a-5(b)(1) (1994); see also I.R.C. § 851(b)(4)(A). Restrictions on the ownership of issuer's voting stock, does not improve portfolio diversification and hurts both investors and the capital market by preventing funds from assuming control positions. See Roe, *supra*, at 1480.

A less ambitious regulatory scheme would not attempt to provide comprehensive rules for eliminating unique risk but would require an administrative agency to set very general guidelines for allocating assets to very broad asset groups, such as large or small companies, and different sectors of the economy, while explicitly allowing active management within the classes.

The most activist approach to this problem would require the government to inject its judgement about the proper asset allocation scheme. I am skeptical, however, about the competence of even the best-intentioned government agency to draft such guidelines. A less interventionist approach would mandate that funds hold the current market-weighted shares in various sectors. This approach, however, would tend to slow down efficient reallocations between sectors, and thus have some of the same drawbacks as a more detailed passive investing scheme.

The least interventionist approach would begin from the perhaps controversial premise that large fund managers tend not to make gross mistakes and to use their decisions as the basis for asset allocation guidelines. These guidelines would not attempt to identify individual stocks or indices but would prescribe guidelines for broadly-defined asset classes such as large companies, small companies, corporate debt and so on. The most difficult aspect of devising these rules is choosing the appropriate pool of large funds. No potential comparison is entirely satisfactory since different funds may have different objectives because, for example, they appeal to clienteles with differing tax situations. The theoretical difficulties in choosing among benchmarks may, however, be of no practical importance, since all three types of funds have remarkably similar asset allocations.⁶⁰

⁶⁰ See Weiss & Sgaraglino, *supra* note 15, at 1206-08.

Proposal Seven

The Social Security system should not attempt detailed regulation of investment decisions. At most, regulations should provide maximum percentages that a fund can invest in a single firm and provide asset guidelines for very broad asset classes.

CONCLUSION

A funded Social Security system holds the promise of solving some of the most basic problems in the current system. However, a funded system may cause more problems than it solves if it is not carefully designed. This Article has considered only one of several problems posed by a transition to a funded system, the investment policy of a funded system.

A funded Social Security system, I have argued, should have the following characteristics:

- (1) The system should consist of individual accounts;
- (2) The individual accounts must be managed by investment professionals
 - (a) who are permitted to manage the accounts actively
 - (b) who are required by law to minimize to the extent possible the level of unique risk
 - (c) who meet specified registration requirements and who can be determined not to be judgement proof
 - (d) but who are given relatively wide latitude in investment decisions, subject, at most, to
 - (i) regulations that provide maximum percentages that fund can invest in a single firm, and
 - (ii) asset guidelines for very broad asset classes.
- (3) Participants should be allowed to choose levels of market risk up to the level of the unleveraged market portfolio, until retirement nears, when they should be required to hold some fraction of their portfolio in relatively risk-free assets.

None of the reform bills currently being considered is wholly consistent with these principles. Several of these proposals would wholly reject the model of decentralized active investing proposed here. Some such bills would provide for a central trust fund or set of funds, administered by a govern-

ment appointed board of trustees.⁶¹ Others would provide for individualized accounts, run by a central government agency along the lines of the Federal Thrift Savings Fund.⁶²

Other bills would, as I have proposed, create a decentralized system of individual accounts run by financial intermediaries. These bills do provide some regulation of the financial soundness of fund managers,⁶³ although in some cases perhaps a less satisfactory framework than the Thrift Savings Fund model. All of these bills propose fiduciary rules which have serious drawbacks. One bill appears simply to incorporate (haphazardly at that) ERISA's inadequate fiduciary rules.⁶⁴

Two privatization bills would provide the following investment guidelines:

(2) criteria for secretarial approval.-the secretary may approve a regulated investment company for purposes of this section only if-

...

(b) the portfolio assets of such company-

(i) replicate the assets of a broad-based index of stocks which is approved by the secretary, or

(ii) are of a type determined by the secretary not to involve high risks for the investor.⁶⁵

⁶¹ See H.R. 4076, 105th Cong. (1998) (Section 2 would amend Title II of the Social Security Act to provide for a central fund in U.S. Treasury (new 42 U.S.C. § 260) invested in a series of index funds (new 42 U.S.C. § 254)); see also H.R. 3456, 105th Cong. (1998) (Section 2 would amend Title II of the Social Security Act to establish in the treasury of the United States a Social Security plus fund like the Thrift Savings Fund (new 42 U.S.C. § 252; new 42 U.S.C. § 256)).

⁶² See S. 1792, 105th Cong. (1998) (Section 3 would establish a system that explicitly followed the pattern of Thrift Savings Fund (new 42 U.S.C. § 255 (a), (b))).

⁶³ See H.R. 3560, 105th Cong. (1998) (creating new 26 U.S.C. § 408b(c)(1)); H.R. 3082, 105th Cong. (1997) ("(c) INVESTMENT REQUIREMENTS—(1) IN GENERAL—Amounts in a personal retirement savings account may be invested only in regulated investment companies (as defined in section 851) which are approved by the Secretary for purposes of this section."); H.R. 2929, 105th Cong. § 408B(b) (1997) (Porter) (Section 4., adding 26 U.S.C. § 408b):

(3) the trustee is a bank (as defined in section 408(n)) or such other person who demonstrates to the satisfaction of the secretary that the manner in which such other person will administer the trust will be consistent with the requirements of this section.

(4) the trustee has registered with the commissioner of social security (in such form and manner as the commissioner may require) as a trustee of individual social security retirement accounts).

Id.

⁶⁴ 105 H.R. 2929, 105th Cong. (1997) (Section 4; creating new 26 U.S.C. § 408b(c)(1)(C)).

⁶⁵ H.R. 3560, 105th Cong. (1998); H.R. 3082, 105th Cong. (1997) (creating new

The requirement that portfolio assets “not . . . involve high risks for the investor” seems to take a step backwards by endorsing the focus on the portfolio reviving the individual prudence rule, and it should be redrafted. The requirement that the portfolio “replicate the assets of a broad-based index of stocks” sounds dangerously like a passive investment requirement.

The fiduciary standard for any individualized Social Security system must flatly require fiduciaries to eliminate unique risk without tying them to a passive strategy. To be sure, some may feel uncomfortable incorporating the technical principles of portfolio theory into such a populist statute. However, allowing unique risk exposes beneficiaries to their own limitations as investors, and requiring passive investment, risks impeding the capital market. The language of finance may be daunting, but the stakes are too high to let discomfort stand in the way of drafting the best possible statute.

